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VENTURE CAPITAL MONITOR

A QUARTERLY UPDATE ON THE CANADIAN VENTURE CAPITAL INDUSTRY

Canadian high growth innovative small and medium-sized enterprises (SMEs) that commercialize research depend to a large extent on the venture capital (VC) industry for funding. Therefore, a strong VC industry is important for the growth of this segment of SMEs. The goal of this series is to provide current information about the VC industry in Canada. To this end, the series will track trends in investment activity, report on topical VC-related research and look at key technology clusters where VC investment is taking place.

INTRODUCTION

This year-end issue discusses Canada's venture capital (VC) activity during 2007, a year characterized by increased foreign investment in large deals and in late-stage Canadian firms. This issue's feature article highlights the ways in which business incubators support high growth innovative SMEs to become investment ready and attract VC investments. It also references a directory of some Canadian incubators. The "In Focus" article presents the Waterloo Region, a hotbed of technology activity and investment.

VC ACTIVITY OVERVIEW

Investment and fundraising

Strong growth in VC investments and a steep decline in fundraising

Venture capital investments in Canada reached $2.05B in 2007 (Table 1), a 21-percent increase over 2006 levels and the largest year-over-year increase since the peak achieved in 2000/2001. Much higher foreign investment levels in the Canadian market and a small number of large deals accounted for the bulk of this increase (Figure 1).

Canadian VC fundraising reached a new low, with only $1.19B raised in 2007, down 27 percent from its 2006 level of $1.63B. Fundraising was mostly concentrated in Quebec, which accounted for 70 percent of all funds raised in 2007.

Table 1

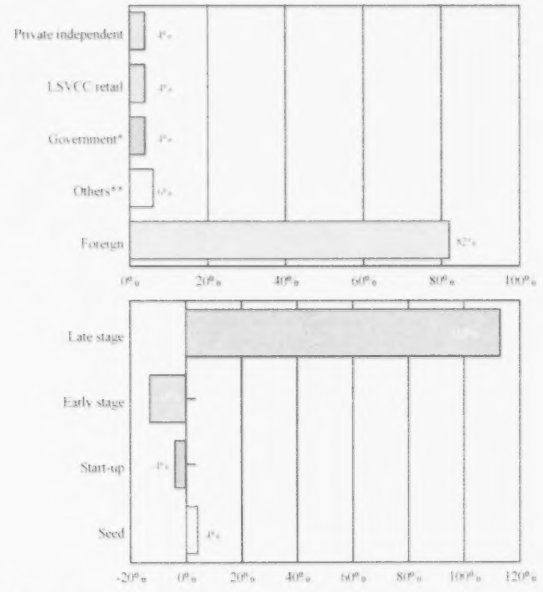
VC investment and fundraising, 2004 to 2007

	2004	2005	2006	2007
	($ millions)			
Investment	1699	1713	1706	2059
Fundraising	1780	2220	1630	1190

Source: Thomson Financial Canada 2008.

Figure 1

Contribution to VC investment growth from 2006 to 2007



Source: Computed by Industry Canada based on Thomson Financial Canada 2008.

* Federal and provincial governments.

** Includes institutional and corporate funds.

Canada

Deal size

A few large deals contributed to a large net increase in average deal size

A small number of large deals made in 2007 drove the average deal size up. That average reached $4.5M, a 22-percent increase from the $3.7M registered in 2006. Notably, 10 of the 457 VC deals made in 2007 accounted for 30 percent of the total VC investment placed in Canada. These 10 large deals were primarily concentrated in the life sciences sector. If these large deals are excluded, the average deal size falls to $3.2M. By comparison, the top 10 VC deals in 2006 accounted for 16 percent of the VC investment in that year. The skewing effect of the large deals on the average deal size and on total VC investment was greater in 2007.

The average deal size made by domestic retail and labour sponsored venture capital corporation (LSVCC/retail) funds, and private independent funds remains consistently lower than that made by foreign funds investing in Canada across different stages of firm development (Table 2).

Stage of development

The increasing share of late-stage investing continues, driven by foreign funds

The share of late-stage investments continued to increase, with 67 percent of total VC investment placed in later stage Canadian companies in 2007 (Table 3). This increase is primarily attributed to foreign funds, which increased their later stage investments in Canadian firms by 62 percent, from $391M in 2006 to $635M in 2007. Foreign investors accounted for 46 percent of all late-stage investments, up 6 percentage points from their 40 percent share in 2006.

The share of VC investments placed in seed and start-up stages decreased in 2007, with the investment level remaining flat at $251M.

New and follow-on investments

Follow-on focus continues through 2007

In 2007, there was a continuation of the trend noted in 2006 towards a concentration on follow-on investments, of which 72 percent involved later stage deals (Table 4). New investments accounted for only 19 percent of total VC investments, with 58 percent of new investments placed in early-stage firms. Moreover, the number of early-stage firms that received funds for the first time has been steadily declining from 191 in 2001 to 84 in 2007.

Type of investor

Foreign funds increased their Canadian investments significantly in 2007

As indicated earlier, the increase in VC investments in 2007 is largely attributed to higher levels of investments being placed in Canada by foreign funds. They represented 40 percent of total VC investment made in Canada during 2007, up 8 percentage points from the 32 percent they represented in 2006. Foreign funds accounted for 82 percent of the increase in VC investments in 2007. Although foreign funds increased their investments by 52 percent between 2006 and 2007 (Table 5), the number of companies receiving foreign funds increased by only 13 percent, indicating that foreign funds made even larger deals in 2007 than they did before.

In comparison, investments made by domestic private independent and LSVCC/retail funds grew by a modest 4 percent between 2006 and 2007.

Table 2

Average deal size ($ millions) by stage and type of investor

	LSVCC/retail		Private independent		Foreign funds	
	2006	2007	2006	2007	2006	2007
Seed	0.80	0.94	1.14	1.78	2.63	N/A
Start-up	1.19	1.27	1.94	1.97	8.96	4.15
Other early stage	1.84	1.46	1.77	2.02	4.79	11.16
Later stages	1.36	1.62	2.34	2.30	9.11	11.15

Source: Thomson Financial Canada 2008

Table 3

VC investment and number of deals by stage of development

	2002–2005	2006	2007	2002–2005	2006	2007
	Amount ($ millions)			Number of Deals		
Seed and start-up	20% 1507	15% 251	12% 251	24% 637	22% 100	20% 92
Other early stage	31% 2331	28% 478	21% 432	31% 819	30% 139	21% 95
Later stages	50% 3766	57% 977	67% 1376	44% 1158	49% 226	59% 270

Source: Thomson Financial Canada 2008.

Table 4

Distribution of follow-on investments, 2003–2007

		2003–2005	2006	2007	2003–2005	2006	2007
		Amount ($ millions)			Number of Deals		
New	Early stages	58% 780	60% 207	58% 223	62% 432	58% 97	49% 84
	Later stages	42% 566	40% 140	42% 163	38% 269	42% 69	51% 86
Follow-on	Early stages	50% 1855	38% 523	28% 469	52% 597	47% 142	36% 103
	Later stages	50% 1819	62% 837	72% 1213	48% 551	53% 157	64% 184

Source: Thomson Financial Canada 2008.

Table 5

Distribution of VC investment by investor type

	2006	2007	% Change
	Amount ($ millions)		
LSVCC/ retail funds	390	405	4
Private independent funds	338	353	4
Foreign funds	548	836	52

Source: Thomson Financial Canada 2008.

Table 6

Distribution of VC fundraising by investor type

	2006	2007	% Change
	Amount ($ millions)		
LSVCC/ retail funds	907	741	-18
Private independent funds	666	447	-33

Source: Thomson Financial Canada 2008.

Fundraising

Declining trends continue for both LSVCC/retail and private independent funds

Fundraising declined for both LSVCC/retail and private independent funds. LSVCC/retail funds raised $741M, down 18 percent from the $907M raised in 2006, while fundraising by private independent funds was down 33 percent from $666M raised in 2006 to $447M raised in 2007 (Table 6).

Regional distribution

VC investment increased in most provinces, with Ontario registering the highest increase

Ontario and Quebec remain the largest recipients of VC investments, accounting for 77 percent of all VC placed in 2007. Venture capital investment in Ontario jumped from $695M in 2006 to $937M in 2007, a 35-percent increase (Table 7). This increase is largely attributed to five very large deals of the 124 deals made in the province. Venture capital investment in Quebec also increased, although at a modest rate of 8 percent from $600M in 2006 to $648M in 2007.

Table 7

VC investments and number of deals by province, 2006 and 2007

	2006	2007	2006	2007
	Amount ($ millions)		Number of Deals	
British Columbia	18% 301	15% 310	13% 52	12% 49
Alberta	2% 37	3% 58	4% 17	4% 16
Saskatchewan	1% 17	3% 55	2% 8	2% 7
Manitoba	1% 25	1% 18	4% 15	2% 9
Ontario	41% 695	46% 937	30% 121	30% 124
Quebec	35% 600	31% 648	44% 178	46% 189
New Brunswick	0% 6	1% 16	1% 6	2% 7
Nova Scotia	1% 24	1% 17	2% 9	2% 10

Source: Thomson Financial Canada 2008.

Table 8

VC investments by sector of activity, 2006 and 2007

	2006	2007	2006	2007
	Amount ($ millions)		Number of Deals	
Life sciences	30% 514	31% 633	21% 96	18% 81
Information technology	52% 888	52% 1067	48% 221	48% 220
Energy and environmental technologies	7% 120	8% 169	6% 26	7% 35
Other technologies	2% 36	3% 6	2% 16	2% 7
Traditional	9% 147	8.7% 184	23% 106	25% 114

Source: Thomson Financial Canada 2008.

Sector distribution

The information technology (IT) and life sciences sectors continued to receive over 80 percent of VC invested

Venture capital investments increased by 23 percent in the life sciences sector from $514M in 2006 to $633M in 2007 (Table 8). This increase can be attributed primarily to a small number of large deals, reflected in the fact that the number of deals decreased by 18 percent.

The IT sector experienced the same trend with investments increasing by 20 percent, from $888M in 2006 to $1067M in 2007, while the number of deals stayed at the same level.

Government activities

Similar to last year, the Business Development Bank of Canada (BDC) invested $113M in 77 deals, nine of which were at the seed and pre-seed stages (Table 9). The total leveraged amount that BDC invested with co-investors reached $721M, which represents a leveraging factor of over five times.

Table 9

BDC deals in 2007

	2007		
	BDC ($)	Co-investors ($)	Number of deals
Seed/pre-seed	7 388 550	11 913 450	9
Start-up	39 053 911	191 288 406	21
Other early stages	43 943 316	290 765 828	24
Later stage	22 705 872	114 689 648	23
Total	113 091 650	608 657 331	77

Source: Business Development Bank of Canada 2008.

The BDC has also invested $30M as a limited partner in two private VC funds, Novacap Technology III and the Government of Ontario venture capital fund.

Sustainable Development Technologies Canada (SDTC) played a key role in the largest VC deal of Q4 2007. An Ottawa-based alternative energy company that secured $54M in VC during the quarter credits SDTC's commitment of a $9.5M non-repayable contribution as being instrumental in attracting VC investors.

Export Development Canada invested $5M in one deal in Q4 2007, with co-investors contributing another $6M.

In December 2007, the Government of Ontario announced a one-year extension to the planned phase-out of the Labour Sponsored Investment Fund (LSIF) tax credit. The full 15 percent tax credit will be offered until the end of 2009 and the credit will not be phased out completely until the end of 2011.

As part of its Action Plan to Support the Quebec Manufacturing Sector, the Government of Quebec, in November 2007, announced a contribution of $25M to the Fonds d'investissement en développement durable (FIDD), a private equity fund that invests in clean technologies and renewable energy sources. Earlier in November, FIDD invested $31.5M in two Quebec-based clean technology companies.

FEATURE SERIES: CREATING QUALITY DEMAND FOR RISK CAPITAL IN CANADA

This series of articles showcases organizations and programs that facilitate the creation of quality investment opportunities for risk capital providers. In this issue, the role that technology-focused incubators play in helping entrepreneurs transform ideas into quality investment-ready propositions for capital providers is featured.

Snapshot: Technology-Focused Business Incubators

Venture capital investors are continually seeking quality investment-grade opportunities. Business incubators can play an important role in providing start-ups and entrepreneurs with much needed support in the form of business advice and services. Incubators can help their client companies become established and better prepared to develop a quality proposition for venture capital investments.

Canada has a number of business incubators in operation. They offer their clients, the incubated companies, a host of useful resources and services that can include

- equipped office space;
- laboratory space, specialized equipment, technical support and library services;
- mentoring, networking and training;
- business planning, management, marketing, accounting and financial advice;
- facilitated linkages to sources of angel, venture capital and debt financing;
- legal support;
- guidance with regulatory compliance; and
- seed capital in some instances.

A 2005 Statistics Canada survey[1] confirmed that Canadian incubators have been successful in supporting the entrepreneurial process within their client companies as evidenced by high levels of client company survival rates and venture capital financing. The U.S. National Business Incubation Association also found that the survival rate of U.S. incubated companies stands at 80 percent after five years of operation, while only 44 percent of all SMEs survive until their fourth year.[2]

Business incubators play an important and useful role by screening potential new client firms based on their market viability. The incubators are motivated to be highly selective in order to maximize their returns and establish a reputation for successful incubation, which in turn attracts the most favourable prospects. The U.S. National Business Incubation Association reinforces this behaviour with annual national awards for the most successful incubators and the most successful incubated enterprises.

Business incubators, especially technology-focused incubators, can be a fertile source of new quality investment opportunities for venture capital investors. A directory of some Canadian business incubators can be found in the HTML version of the *Small Business Quarterly*, February 2008, at **www.ic.gc.ca/epic/site/sbrp-rppe.nsf/en/rd02276e.html**.

"IN FOCUS" — WATERLOO REGION

The Waterloo Region has — through innovation, entrepreneurship and investment — continually transformed itself over the last century from a region known for textile mills and farmlands into a magnet for multinationals and a hotbed for cutting-edge technology start-ups, investment opportunities in next-generation companies and locally developed world-class corporations. Its success has been attributed largely to the culmination of a number of factors that include a dynamic entrepreneurial culture, a diverse economy, a strong set of post-secondary institutions, and supportive business and innovation structures.

Dynamic entrepreneurial culture

The region is small and enjoys a thriving entrepreneurial culture that promotes a strong sense of community and collaboration among businesses and with local governments. These collaboration and knowledge exchanges are facilitated by a number of supporting business and innovation structures that are funded by local industries, community leaders, educational and research institutions, and local and other levels of government. Table 10 shows that a large number of local graduates remain in the region and form a significant part of the executive pool in local companies. Many of these are entrepreneurs who have worked in a number of local firms, which helps to strengthen networks and promote knowledge and technology diffusion in the region.

Diverse economy

The region enjoys a diversity of sectors performing R&D, including advanced manufacturing, biotechnology, the environment, hardware, medical devices and services, photonics, digital imaging, information technology, software, telecommunications, defence, aerospace, robotics, wireless applications and devices, and multimedia. This diversity, concentrated within the region, coupled with the entrepreneurial culture, permits knowledge exchanges that further drive innovation and new business opportunities.

Concentration of post-secondary institutions

The region benefits from the presence of strong post-secondary institutions, such as the University of Waterloo,[3] known for its engineering and mathematics departments; Wilfrid Laurier University,[4] with its Schlegel Centre for Entrepreneurship; University of

[1] Joseph, Robert, Michael Bordt and Daood Hamdani. Characteristics of Business Incubation in Canada, 2005. Ottawa: Statistics Canada, 2006.

[2] Knaup, Amy E. Survival and Longevity in the Business Employment Dynamics Data. *Monthly Labor Review*, May 2005.

[3] **http://www.uwaterloo.ca/**

[4] **http://www.wlu.ca/**

Table 10

Characteristics of the Waterloo Region technology cluster in 2006

	Information and communications technology	Science, technology and engineering	Advanced manufacturing	Biotech, life sciences and environmental industries
Employment levels (workers)	13 300	5 100	9 200	1 400
Portion of total revenue generated outside of Canada	-	60%	67%	-
Portion of firms seeking financing	-	27%	29%	-
Portion of firms that are privately owned	56%	72%	-	55%
Portion of firms planning to expand their workforce	82%	87%	60%	75%
Portion of the pool of executives that are local alumni	66%	59%	75%	+50%
Number of firms	284	65	58	58

Source: Communitech, 2006. State of the Industry, Technology in Waterloo Region.
http://communitech.esolutionsgroup.ca/investor_centre/research_centre.shtml

Guelph,[5] known for agriculture and environmental sciences; and Conestoga College.[6] In addition, the region is home to a number of world-class centres of excellence, including the Perimeter Institute for Theoretical Physics,[7] the Institute for Quantum Computing[8] and others that span a knowledge range from engineering to robotics to nanotechnology.

Supportive business and innovation structures

Local government, industrial, academic and community leaders have helped establish community-based business and innovation structures, with some provincial and federal support, that are contributing to the region's ability to commercialize ideas and innovate. These structures include the Accelerator Centre,[9] a not-for-profit technology business incubator that opened in 2006; the University of Waterloo Research and Technology Park,[10] designed to be a catalyst for resident enterprises to achieve technological breakthroughs, in part as a result of easy access to a vibrant research community; and Communitech,[11] Waterloo's member-driven technology association.

Indeed, the Waterloo Region technology cluster has earned impressive returns for its investors. The Communitech report, *Making Magic in the Waterloo Region*,[12] highlights the excellent financial performance that the Waterloo Region has enjoyed in the recent past, including

- an average sevenfold increase in value for investments placed in local firms at the time of exit;
- $1.8B in acquisitions over the 10-year period ending in 2005;
- an internal rate of return of 26 percent earned by a portfolio of Waterloo Region public technology firms; and

[5] **http://www.uoguelph.ca/**

[6] **http://www.conestogac.on.ca/**

[7] **http://www.perimeterinstitute.ca/**

[8] **http://www.iqc.ca/**

[9] **http://www.acceleratorcentre.com/home/index.php**

[10] **http://www.uwrtpark.uwaterloo.ca/**

[11] **http://www.communitech.ca/en/**

[12] **http://communitech.esolutionsgroup.ca/investor_centre/research_centre.shtml**

- local firms that accounted for 10 percent of all technology initial public offerings on the Toronto Stock Exchange from 1996 to 2004.

Recent Thomson Financial data show that venture capital investments in the region have been in decline, posting VC investment levels of $46M in 2005, $36M in 2006 and $25M in 2007. However, there are indications that the angel investment community is very active within the region. A 2006 Communitech-funded survey[13] of high-technology firms in the region of Waterloo found that the two main challenges facing local firms are financing growth and finding and retaining talent. Nevertheless, the region has a strong track record, a robust infrastructure and a strong entrepreneurial community that paves the way for continued success in generating quality opportunities for angel and venture capital investments.

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NOTES

This publication is part of a series prepared by the Small Business Policy Branch. The branch analyses the financial marketplace and how trends in this market impact small businesses' access to financing. Current research is focused on high-growth firms, the aspects of both Canada's VC and general business environment that affect the success of these firms, and the key players in the risk-capital market (for example, VC firms and angels).

The Small Business Policy Branch is also responsible for the Small and Medium-Sized Enterprise Financing Data Initiative (SME FDI). The SME FDI is a comprehensive data-collection program on SME financing in Canada. In partnership with Statistics Canada and Finance Canada, Industry Canada reports on the supply of and demand for financing by small and medium-sized businesses. Further information and statistical findings and reports are available at **www.sme-fdi.gc.ca**.

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Multimedia Services Section
Communications and Marketing Branch
Industry Canada
Room 264D, West Tower
235 Queen Street
Ottawa ON K1A 0H5

Tel.: 613-948-1554
Fax: 613-947-7155
Email: **multimedia.production@ic.gc.ca**

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